TESTIMONY OF
STATE TREASURER PHIL ANGELIDES
TO ASSEMBLY BUDGET COMMITTEE

State Capitol
November 25, 2003

Two weeks ago, I released the Annual Debt Affordability Report. This is a statutorily required report in which annually we normally discuss how much bond issuance the State can afford for future capital projects. But this year, I have devoted the focus of the report to the issue of deficit financing and what that means in terms of the State's bond position and its position in the capital markets. I indicated in that report that I believe we already have authorized too much deficit financing.

I noted that we have an extraordinary opportunity – with the inauguration of a new Governor and with this special session – to reduce the amount of borrowing we have authorized, and in no event to expand that borrowing. And in fact, we should mark this as the day when we start moving toward a structurally balanced budget. I thought it was an extraordinary opportunity – given the turmoil of the recall we have been through – to put everything on the table, including cuts and revenues, and to truly balance the books.

I also thought, given the Governor's own promises, that he would move us toward a balanced budget that protected education, healthcare for children and public safety.

Now, in general terms, I want to note four concerns about the level of borrowing that we already have authorized in the 2003-04 budget.

The first concern is that these borrowings come with a real cost. They are not magic money. They do need to be paid. And what they mean is future budget carve-outs that will diminish fund availability for programs or alternatively, lead to tax increases of a greater magnitude should people want to restore or maintain program levels. Unlike bonds for schools and parks and water, at the very end of deficit borrowing, we are left with nothing except the bill having been paid. On a financial and moral ground, I do not believe we should put these deficits on the credit card bills to be paid by our children and grandchildren.

The second generic concern about the level of borrowing already assumed involves our debt ratio. We have always been a moderate debt state in terms of the other 10 industrial states in this country, but with the deficit borrowing approved to date, we would be jumping over the 6 percent level that is normally considered prudent. And that kind of debt ratio would begin to crowd out the real investments we need to create the best kind of business climate in California. We must be able to afford the infrastructure needed to support a growing economy.

Thirdly, I noted in the report that I believe that we were already stretching market capacity. Let's be clear. There is not an unlimited appetite for our borrowing. New York

City thought there was in 1974-75, and it kept borrowing until the day came when the capital market said, no mas. And the reality is, that the most we have ever sold in general obligation bond debt in this State in one year is $6.6 billion dollars. That was last year. With the borrowings authorized already in the budget, we would be in the market this year for about $18 billion dollars of borrowings backed by the General Fund. You have to keep in mind that the primary buyers of our debt are the people who get both the federal and the State tax exemption, so this is not a limitless international market. And again, the more we are borrowing for debt, the less capacity we have for the investments that really do count for our future.

Finally, and I think most importantly, I pointed out – and I think it's something we all know – that this borrowing does nothing to move us toward a balanced budget – zip, nothing. It's akin to a family with an income of $60,000, spending $70,000, and solving their problem by borrowing $10,000 with a home equity loan. It does nothing to move us toward a truly structurally balanced budget, and nothing to restore the credit ratings to the State.

Let's be clear about this. The prime reason we have a diminished credit rating in this State is because the rating agencies have pointed to our inability to structurally balance the budget. So before I talk about the Governor's proposal, let me just say again that this is an extraordinary opportunity to finally move to a balance we all know has to be achieved – if not tomorrow, or the next day, in the next month. Delay does us no good. I said to the Governor directly: It seems to me that if we want to make an honest effort to do this, everything should be on the table – both cuts and revenues – and borrowing as a last resort.

Now, let me just comment briefly about the Governor's proposal. In my mind, the Governor's proposal goes the wrong way, not the right way.

Number one: Notwithstanding what Ms. Arduin said -that it's $15 billion to cover the refinancing of our existing obligations – which are really $25 billion – let's be clear: his package will increase the amount of deficit borrowing beyond what you authorized and beyond our current plan by about $4 billion dollars. I don't care how you package it – it is more borrowing, not less. Our office intended to go to the markets this year, should the legal challenges be overcome. At this point, the package would be $10.7 billion dollars in deficit borrowing – fiscal recovery bonds. The gross amount would be 10.9 billion, plus $800 million in Pension Obligation Bonds for a total of $11.7 billion. Under the Governor's plan, the gross amount would essentially be $15.5 billion, and in just a few minutes I will talk about why it is more than $15 billion. There are indications that the administration still wants to sell the pension bonds, if, in fact, they are upheld in court. With the pension bonds, the total would be $16.3 billion dollars, a very substantial increase in what we intended to market. Make no mistake about it, it is more borrowing; it is not just repackaging.

Secondly, the borrowing extends the term of the borrowings from 5 years to 15 to 30. This means we would pay higher interest rates because when you borrow short-term, you borrow at lower interest rates. As you know, when you buy one-year Treasuries or 10-year Treasuries, there is a difference in the rates. And clearly, we have now moved from a five-year structure to one in which potentially my 25-year-old daughter who just got out of the Peace Corps, will be making her last payment at age 55. These are very different kinds of borrowings.

Not to be too flip, but it seems to me for the first time in California, we are going to be asking not what we can do for our children and grandchildren, but what they can do for us. It is not a good move for any of us, regardless of party.

Thirdly, the Governor's borrowing proposal does not move us toward a balanced budget. A $15 billion bond does not contain any real budget solutions. It is not in the context of a larger plan in which you could justify borrowing $15 billion or $17 billion dollars because you have seen a strategy.

If this were the corporate world and the previous CEO had lost his job because his company had accumulated too much debt and there was an ongoing operations loss, the first move by the new CEO would not be to say, "I'm going to borrow more money without regard to an overall plan to reduce the operating losses of the company." And the fact is, even with this borrowing, you and I and the Governor are all going to be back here in June of 2004 with a $14 billion problem.

Finally, the Governor's proposal does not help us with the credit rating agencies in any regard.

As for the spending cap, I disagree with State Finance Director Arduin flat out. The spending cap does nothing to help us sell these bonds nor will it restore our credit rating in any fashion. The fact is that the spending cap in many ways is the illusion of a balance without balance. Again, a family that has an income of $60,000 a year, and spends $70,000 a year, saying we are going to get tough on ourselves and cap our spending at $70,000, does not solve its $10,000 problem. Wall Street is smart enough to figure that out. They know we still have a gap between revenues and expenditures.

They take a very simple view. They want to make sure if you are borrowing, that at the end of the day you have the capacity to pay your operations and your debt service. That is what bondholders want.

So I would urge you to reject the Governor's plan. I would urge that before you take any action on a bond plan, to first of all make every effort to reduce the existing amount of indebtedness, not expand it. And I would ask for a comprehensive plan that shows how this $15 billion dollars – which by the way, is not chump change – fits into an overall plan to achieve the fiscal balance that was the promise of the recall. It seems to me, given the turmoil we've all been through, that we have a right and an obligation to ask and demand a larger plan that shows how we are going to achieve fiscal balance.

I just wanted everyone to recognize there are real costs to these bonds. They're not magic money. They are like a credit card. They will come due.

Now, I would like to go through a set of charts that I think put some numbers on the issues I have been talking about today.

Chart #1: (Outstanding General Obligation Bonds, Actual and Projected) shows the amount of General Obligation Bonds that we have outstanding. From 1998-99 to the end of 02-03, the amount climbed from about $16 billion dollars to over $26 billion dollars. The bar on the far right shows that by the end of the 03-04 fiscal year, given the current sales schedule, California's outstanding General Obligation Bonds will total about $32.35 billion. The Governor's proposed deficit bonds would add $15.57 million to that, for a grand total of nearly $48 billion in outstanding indebtedness. These deficit bonds would represent a 48 percent increase in outstanding General Obligation Bonds.

Even when we get to the end of 03-04, we still will have $18 million that the voters have already approved that we have not yet issued from past bond issues. There is additional debt that has to be accommodated that does not include the $18 billion. Nor does it include the Education Bond, which is on the March ballot, or the High Speed Rail Bond on the November ballot.

Chart # 2: (Financial Impact of Governor's Proposed General Obligation Deficit Bonds) The par amount would be $15.57 billion because it includes underwriters' fees, bond counsel, financial advisors, and fees to the rating agencies. The Governor's proposal actually authorizes up to $17 billion dollars to get $15 billion in net proceeds. The chart shows the cost of both a 15-year bond and a 30-year bond. The annual debt service is shown, and the total cost at maturity. The cost of a bond with a 15-year maturity would be more than $23 billion. A bond with a 30-year maturity would cost $34.98 billion. The total cost per household would be just over $2,000 per household for the 15-year bond, and more than $3,000 per household for the 30-year bond.

The Department of Finance assumes that for a 15-year bond the true interest cost, the blended overall interest cost, would be about 6.01 percent. They assume for a 30-year bond, the interest rate would be about 6.64 percent. And these are on uninsured bonds. We do not believe you can get insurance for these General Obligation Bonds.

To put that in perspective, that's about 1-1/2 points higher than our last General Obligation Bond sale when the rate was approximately 5.20 percent. It reflects the financial advisors' view and my view that when you try to put this much General Obligation Bond debt into this market for which there is a finite set of buyers – a market separate from a dedicated revenue source bond market – you're going to impact interest rates. There's just no question about it, and the Governor's own analysis shows a 1-1/2 percent interest rate increase.

This means – and it's not on the charts – that on a $15 billion-dollar 15-year term bond that you will pay about $2 billion dollars more in interest. On a $15 billion 30-year term bond, you will pay approximately $3.7 billion. We are in uncharted waters in trying to put this much debt in the market.

Now how does that stack up against the interest costs of the $10.7 billion, five-year Fiscal Recovery Bonds you've already authorized? The debt service cost for the five-year Fiscal Recovery Bonds is around $995 per household. Both of the Governor's plans are dramatically more expensive, given the longer term and the higher interest rates that you pay for long-term debt. And as I have cited to you many times, it is our opinion that a Dedicated Revenue Stream Bond would have lower interest rates than would additional GO debt. And in pure dollar terms, a 15-year General Obligation Bond would cost $11.7 billion more than a 5-year Dedicated Revenue Stream Bond. A 30-year GO bond would cost the taxpayers about $23.6 billion more in principal and interest than a 5-year Dedicated Revenue Stream bond to pay off deficits.

Chart #3: (Ratio of Debt Service to General Fund Revenues Accounting for Governor's General Obligation Deficit Bond Proposal) The broken line across chart shows the benchmark 6 percent debt service ratio to General Fund Revenues would be exceeded in 2004-05, 2005-06, and 2006-07 fiscal years if the Governor's bond proposal is adopted.

The Legislative Analyst has always said that 6 percent is the right benchmark, and generally in the industry, that is considered to be at the bounds of prudence. But on April 2nd of last year, the Senate Republican Caucus produced an analysis that said 5 percent should be our benchmark. Then on April 30th, they released an analysis that discussed additional bonds for capital projects. This is their quote: "When the State is struggling with a budget deficit approaching $40 billion, the answer to additional bond debt may be a resounding no."

There has been some discussion that because of these debt service ratios, that we should consider delaying school bonds or other bonds for capital projects. I think this would be the worst thing we could do for California's economy and business climate, and the worst thing we could do short-term because every dollar of capital spending creates $2.50 in economic stimulus – jobs and additional spending – by those employed, along with the long-term benefits.

One more comment on this chart. When you get to '06-'07, we will still have significant amount of bonds to be sold based on what voters have already approved and what might be approved on the '04 and '06 ballots. So this can't be looked at in a vacuum. This trend will continue for years. Let's go to the next chart.

Chart #4: (Planned Bond Issuance Under Governor's Proposal – Fiscal Year 2003-04) The first bar shows the deficit that is the sum of the tobacco bonds, pension obligation bonds, and general obligation deficit bonds as proposed by the Governor. The other three bars for schools and other capital investments total $6.1 billion.

The Governor is proposing more general obligation, or State budget-backed debt, than ever before. And while traditionally we've just issued debt for capital purposes – schools, water, parks – during this year, if this proposal passes, when you add the Tobacco Bonds that we have already sold (which are backed by the General Fund), the $800 million in Pension Obligation Bonds which are essentially backed by the General Fund, and the $15.57 billion dollars in GO Bonds proposed by the Governor, this year we would be in the market for $18.68 billion dollars of deficit-related borrowings and a total of only about $6 billion for capital investments in California's future.

And I just want to say again that it's okay in my mind for a family to stretch to buy a house because they get asset accumulation, or to help send their kids to college, I don't think it is appropriate use of our bonding capacity to have this kind of ratio between deficit borrowing and capital investment. Let's go to the next chart.

Chart # 5: (Outstanding General Obligation Bonds – Actual and Projected) This chart shows the sales, historically, of General Obligation Bonds in the marketplace.

If you were to go back a number of years, the State has been in the market for $3 to $4 billion in General Obligation Bonds in any given year. Last year we hit a peak of $6.6 billion for school, park, and water bonds. This year we project selling $6.10 billion. When you add all the deficit borrowings, we will be in the market for an astounding $24.78 billion dollars in budget-backed bonds.

This stretches our credibility in the marketplace. We are taunting the market. I cannot tell you, nor predict to you what kind of interest rates we would be paying in the market.

What is important to say about this chart is that the Governor's proposal expands by about $4.6 billion dollars, the aggregate amount of borrowing that has already been approved by this Legislature.

Now let me just make a few comments about the Governor's proposal with respect to structure, and talk about a couple of specific issues about the Governor's proposal. As I indicated, the bonds would be in excess of $15 billion to pay for all the costs of issuance, and the legislation authorizes up to $17 billion. The Governor's Office talked about, potentially, having to insure General Obligation Bonds. It is our firm opinion in our office that this is not going to be a possible.

Insurers have reached their capacity in terms of General Obligation Bond insurance they are willing to provide us. Earlier this month my staff met with the four leading bond insurers and they confirmed that their capacity constraints would continue for the foreseeable future.

So in our mind there is no question that if you are going to go down the road of trying to provide legal insurance by having voter-approved bonds, my view is, first, that you ought to strive as much as possible to have them be less than $10.7 billion so we can move toward structural balance.

But you will eventually be expanding what you ask the voters to approve. However, if you go the route of putting something on the ballot, it should be a bond measure with a dedicated revenue source. And there is no question in our mind that those types of bonds will get higher ratings and lower interest rates. There are a couple of reasons for that.

Number one, there isn't any more capacity to insure General Obligation Bonds. There are limits in terms of how much exposure insurers are going to take from one credit, and they view General Obligation Bonds as a single credit. On the other hand, they view a dedicated revenue stream as a different credit, and they have indicated to us that they believe there would be significant insurance capacity available for Dedicated Revenue Stream Bonds. That is one reason that you would end up, in our minds, with the possibility of lower interest rates and higher ratings.

Secondly, investors have portfolio constraints where they do not want to hold more than X percent of any single credit. We are butting up against the capacity constraints by buyers on plain vanilla GO bonds. And, again, a Dedicated Revenue Stream Bond would be viewed as a different credit apart from all other obligations in the State by the buyers of our bonds. So that's the important point.

But if you are going to place any deficit bonds before the voters, I don't believe you ought to do that unless it is in the context of a comprehensive plan to balance the budget, or at least a road map produced by the Governor. And I also believe that if deficit bonds are going to be considered, you should be looking at shorter-term debt, which provides lower interest rates, overall lower costs and will not have the same kind of impact on the budget in terms of squeezing out programs over a 15 and a 30-year timeframe. And, of course, which won't have what I think is the immoral effect of passing on our debt to our children and grandchildren.

Another specific issue on the Governor's plan that I want to just note is timing. We believe it is going to very difficult to move that much in the way of General Obligation Bonds into the market in a single year or even in a series of bonds close together. And, therefore, even if you go the route of General Obligation Bonds, we would probably have to do short-term borrowings to bridge to the ultimate sale of those General Obligation Bonds. We believe the market would want to see a comprehensive plan with respect to budget balancing if we are going to be successful in arranging those short-term notes. They don't want to just lend us credit on a wish and a prayer. They would like to lend us credit based on the fact that we have a way of exiting our fiscal problems.

Let me close with these thoughts. I believe very strongly that we have already authorized too much deficit borrowing. I believe the first charge of the Governor and then the Legislature – once he gives you specific plans – should try to shrink the amount of borrowing, even that which is put before the voters. I believe that you should not approve a bond package of this magnitude – which is an increase in bonding beyond what we have already approved – without seeing a comprehensive plan that moves us toward structural balance. That is what we must have and that is what the markets will ultimately want to have.

And I believe – not to be too glib here – but, yes, there will be casualties, perhaps severe casualties, if we move forward with this bond and by that I mean the financial standing of the State of California in future generations. So I believe you should reject this plan as proposed. You should look at reducing the amount of bonding. You should look at the alternative structure of the dedicated revenue source, and you should act in the context of a full plan put before you by the Governor that is consistent with his promise to balance the budget and protect fundamental programs such as education, healthcare, and public safety.

May I respond to something Ms. Runner raised this morning – just for the record – about what we did in the way of refinancing last year?

We did do some refinancings of the existing State debt, and what you can see there is the blue line. (See accompanying chart, "The Strategic Debt Management Plan provides significant near-term savings…" The chart shows the plan providing significant near-term savings, with offsets in future years. Overall the plan resulted in lower present value costs than the then-current practices.) This chart was produced for the press and sent to the Legislature in January of 2002. We did a refinancing in this period, which lowered our debt service payments for the last two budgets; and we were very clear that it would, in fact, save us money now. But this was the exact chart that we used two years ago, so I didn't doctor it up. And we were very clear that when you come to 2007-8, actually 2008-9, we would begin to have more in the way of debt service payments, so we did do some refinancing that saved money now, but we were very clear we would have more costs later on. You're correct; we did that, Ms. Runner.

But I want to talk about magnitude here. And just to put this in perspective, here is what we did. (See accompanying chart, "Strategic Debt Management Plan and Governor's Proposed GO Deficit Bonds, Comparison of Scale") We refinanced $3.04 billion of obligations – principal obligations that would have been due over a 5-year period. Now my view was that this was prudent but aggressive, and I might add I was criticized by both Assemblyman Cox, who's a dear friend of mine, and Senator Brulte, saying I did too much refinancing. But this is the sum total of what we refinanced, $3.04 billion.

The Governor is proposing to finance $15.57 billion in obligations due today. We refinanced this amount (indicating $3.07 billion).

Now the question is, was this reasonable? I think it was, but I think it was the most we should have done. And I was very clear about it. If I had thought we should have done more, I would have done more, because I had the authority to do it. But I didn't think that would be prudent.

What is now proposed is that we add another $15.57 billion of today's payments stretched over 30 years; and the analogy I'd give you is this: It's okay to have a glass of wine at dinner. It's not okay to have six and then go out driving. And my view is, I just want to put it in perspective. There is a world of difference between $3.04 billion dollars and adding $15.57 billion, which brings our refinancings to over $18 billion.